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Taxation Section

VOLUME 11, NUMBER 1**SPRING 2008**

The Oregon Business Energy Tax Credit

By Neil D. Kimmelfield, Lane Powell PC

The Oregon Business Energy Tax Credit (“BETC”) is a nonrefundable credit against Oregon personal and corporate income taxes based on the “certified cost” of certain investments in energy conservation, recycling, renewable energy resources, or reduced use of polluting transportation fuels. Originally enacted in 1979, the BETC was significantly expanded in 2007,¹ and expanded again in 2008,² as part of an effort to encourage alternative energy development. The BETC is available only for investments in facilities that are completed by the end of 2015.³

This article will summarize (1) the structure of the BETC statutory provisions, (2) the types of investments that are eligible for the BETC, (3) the amount of BETC allowable with respect to particular investments, (4) the process for obtaining BETC certification of an investment, (5) the monetization of the BETC through the so-called “pass-through” program, and (6) areas of uncertainty in the BETC rules.

Structure of the BETC Statutory Provisions and Administrative Oversight

The BETC is allowed under ORS 315.354. Most of the statutory rules relating to the BETC, however, are contained in ORS Chapter 469. The link between ORS Chapters 315 and 469 is established by two provisions in ORS 315.354. First, ORS 315.354(1) provides that the allowable BETC is “based upon the certified cost of the facility during the period for which that facility is certified under ORS 469.185 to 469.225.” Second, ORS 315.354(3) provides: “In order for a tax credit to be allowable under this section *** (b) [t]he facility must have received final certification from the Director of the State Department of Energy under ORS 469.185 to 469.225; and (c) [t]he taxpayer must be an eligible applicant under ORS 469.205(1)(c).”

The Department of Revenue has issued limited guidance under ORS 315.354, deferring to the Department of Energy (the “DOE”). In particular, OAR 150-315.354(2) provides: “For facilities receiving preliminary or final certifications issued by the Office of Energy on or after January 1, 2001, the credit may be claimed by eligible applicants under ORS 469.205(1)(c) and the related administrative rules. See Chapter 330, Division 90 of the Oregon Administrative Rules (e.g., OAR 330-90-0105) for additional information.”

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Due to the certification requirements set forth in ORS 315.354, the DOE has a substantial “gatekeeper” role in the allowance of BETCs. Thus, projecting BETCs with respect to an alternative energy project is more speculative than projecting energy-related federal income tax credits, which may be claimed on a federal income tax return based on the taxpayer’s own determination that it is eligible for the claimed credits.⁴

Investments Eligible for BETCs

BETCs are available with respect to a wide array of “green” investments (referred to as “facilities” under the BETC rules), including certain investments, made in connection with a trade or business, that accomplish any of the following objectives:⁵

- Use of a renewable energy resource or solid waste instead of electricity, petroleum, or natural gas.
- Use of a renewable energy resource in the generation of electricity for sale or to replace an existing or proposed use of an existing source of electricity.
- Substantial reduction of the consumption of purchased energy.
- Acquisition, construction, or installation of equipment for recycling.
- Acquisition of an alternative fuel vehicle or conversion of an existing vehicle to an alternative fuel vehicle.
- Acquisition, construction, or installation of a facility necessary to operate alternative fuel vehicles.
- Acquisition of transit passes for use by specified individuals.
- Acquisition of a sustainable building practices facility.
- Acquisition of a car sharing facility and operate a car sharing program.
- Construction of a high-efficiency combined heat and power facility.
- Construction of a homebuilder-installed renewable energy system.
- Construction of a home meeting standards for reduced energy consumption established by the Department of Energy.

- Acquisition, construction, or installation of a renewable energy resource equipment manufacturing facility.

Amount of the BETC

The amount of the BETC allowed with respect to a facility in each taxable year is based on (1) percentages and timing rules set forth in ORS 315.354, (2) the final cost for the facility certified by the DOE under ORS 469.215 (which is limited by the maximum eligible cost for the facility under ORS 469.200), and (3) the period for which the DOE’s cost certification is effective, as determined under ORS 469.220.

The maximum BETC allowable with respect to a facility depends on the nature of the facility. In the case of a facility that “uses or produces renewable energy resources or is a renewable energy resource equipment manufacturing facility,” the allowable BETC is 10% of the facility’s certified cost per year for five years, for a total of 50%. ORS 315.354(1)(c). In the case of an eligible renewable energy system installed by a homebuilder in a single-family dwelling, the maximum allowable BETC is \$9,000 per dwelling (or \$12,000 if the dwelling is a “high-performance home”). ORS 315.354(2) and (4). In the case of any other facility, the allowable BETC is 10% of the facility’s certified cost in the first two years of the five-year period for which the certification is effective, and 5% in each of the remaining three years, for a total of 35%. ORS 315.354(1)(a).⁶

In all cases, a taxpayer’s BETC for a taxable year may not exceed the taxpayer’s Oregon income tax liability. Any amount that is not allowed for a taxable year by reason of this limitation may be carried forward for eight years. ORS 315.354(6).

Process for Obtaining BETC Certification for a Facility

The process of obtaining BETC certification from the DOE for a facility involves two steps. First, the owner of the facility must complete an application for preliminary certification and submit it to the DOE, together with a supplementary information form and a fee to cover the review of the application. The information that must be provided in the application includes owner information, site location, construction dates, a description of the project, economic data, and estimated project costs. ORS 469.205;

OAR 330-090-0130. The DOE generally requires the application to be submitted before work commences on a project. OAR 330-090-0130(3).

Under OAR 330-090-0130(3), within 60 days after the application for preliminary certification is filed, the DOE will “decide if it is complete,” and the DOE will act on the application “within 120 days after a completed application is filed.” According to the DOE’s application forms, review of the application usually take four to six weeks to complete. If a preliminary certification is issued, it will specify “the amount of the tax credit approved” and also will state “any conditions that must be met before development, final certification, or some other event can occur.” OAR 330-090-0130(3)(b)(A).

If, during the course of construction, it appears that project costs will exceed the amount stated in the preliminary certificate, the project owner may apply for an amended preliminary certificate by submitting written documentation of the increased costs. OAR 330-090-0130(7).

While a project owner may begin (and even complete) work on a project before receiving a preliminary certification, there is no guarantee that a project will be approved for the BETC.

Once the project owner has obtained preliminary certification and has completed the project, the owner must file a final certification application. This application includes an affirmation that the project complies with conditions of the preliminary certificate and a verification of actual project costs. The amount of BETC certified by the final certificate may be as much as 10 percent more than the amount approved in the preliminary certificate. OAR 330-090-0130(9)(b)(A).

Monetization of the BETC Through the “Pass-Through” Program

Under ORS 469.206, “[t]he owner of a facility may transfer a tax credit for the facility in exchange for a cash payment equal to the present value of the tax credit.” The DOE refers to the transfer of the BETC as a “pass-through” and refers to the transferee as a “pass-through partner.”

Based on permissive authority in ORS 469.206(2), the DOE has issued rules arbitrarily determining

the “present value” of the BETC for purposes of this rule (referred to by the DOE as the “pass-through rate”). Under OAR 330-090-0140(1), in the case of projects with certified costs exceeding \$20,000, a pass-through partner must pay the project owner an amount equal to 33.5% of eligible costs in exchange for a transfer of the 50% BETC, and 25.5% of eligible costs in exchange for a transfer of the 35% BETC. In the case of projects with certified costs of \$20,000 or less, the pass-through rate is 43.5% in the case of the 50% BETC and 30.5% in the case of the 35% BETC.

If a project owner chooses to transfer the BETC to a pass-through partner, the pass-through partner must be identified when the final certification application is filed, and the pass-through partner must file a pass-through option application form. OAR 330-090-0130(8).

If an owner desiring to use the pass-through option has completed its project but has not yet secured a pass-through partner, the DOE will place the application on hold until a partner is identified. When a pass-through partner is secured and the “Application for Final Certification for Pass-through Projects” is completed and signed, the DOE issues a letter to both the project owner and the pass-through partner verifying the final eligible costs, the pass-through amount, and the tax credit amount. The pass-through partner gives the project owner the lump-sum cash payment indicated on the letter and the project owner notifies the DOE that the pass-through payment has been received. The DOE then issues a tax credit certificate in the name of the pass-through partner.⁷

Areas of Uncertainty

The extent of the DOE’s discretion to impose conditions on project owners and others in connection with the certification of project costs for the BETC is unclear. ORS 469.205(2)(f) provides that an application for preliminary certification shall include “[a]ny other information the [DOE] considers necessary to determine whether the proposed facility is in accordance with the provisions of ORS 469.185 to 469.225, and any applicable rules or standards adopted by the [DOE].” ORS 469.210(2) provides: “If the [DOE] determines that the proposed acquisition, erection, construction or installation is technically feasible and should operate in accordance with

the representations made by the applicant, and is in accordance with the provisions of ORS 469.185 to 469.225 and any applicable rules or standards adopted by the [DOE], the [DOE] shall issue a preliminary certificate approving the acquisition, erection, construction or installation of the facility.” ORS 469.197, adopted in 2007 and recently amended by HB 3619, establishes economic-impact criteria that DOE may take into account in certifying renewable energy resource manufacturing facilities, but that provision does not apply to the certification of other types of facilities. Ultimately, it is not clear whether the DOE has the authority to impose conditions or standards other than conditions and standards that implement the provisions of ORS 469.185 to 469.225. It also is not clear whether the DOE may impose conditions on certification other than through the rule-making process. There is no case law regarding the scope of the DOE’s authority to impose conditions on the certification of facilities for the BETC.

Another area of uncertainty is the ability of S corporations and entities that are taxed as partnerships for federal income tax purposes to obtain final certification of facilities for the BETC or to be transferees of BETCs under the pass-through program.

The instructions for Form 65 (Oregon Partnership Return of Income) state: “Partners may qualify for the following tax credits on their individual income tax returns even though the costs were paid by the partnership. *** Business energy.”

Nonetheless, in a proposed OAR dated December 1, 2007, and most recently reissued in proposed form on January 14, 2008, the DOE included definitions that would prevent a partnership, or a limited liability company (“LLC”) taxed as a partnership, from applying for final BETC certification.

Proposed OAR 330-090-0110(4) provides, in part:

(b) A person who applies for a final certification of a Business Energy Tax Credit under this section:

(A) Must be a taxpayer
(see definition for “Taxpayer”).

Proposed OAR 330-090-0110(69) provides:

“Taxpayer” means an individual, estate, or trust subject to tax under ORS Chapter 316, or a corpo-

ration subject to tax under ORS Chapters 317 or 318. The term does not include partnerships or other entities not subject to tax.

Under these proposed definitions, an S corporation, a partnership, or an LLC taxed as a partnership would be permitted to file an application for preliminary certification but would not be permitted to file an application for final certification. The proposed OARs were criticized at the DOE’s public hearing on January 15, 2008, and the DOE subsequently announced that it would not release the final OAR on February 1, 2008, as originally planned. The rule-making may be monitored at the following page on the DOE website: <http://www.oregon.gov/ENERGY/CONS/Rulemaking2007-BETC.shtml>.

Concluding Comments

The BETC is a powerful stimulus for the development of renewable energy resources and the “alternative” energy industry in Oregon. BETCs, in combination with Federal tax credits and other available subsidies, can reduce the after-tax cost of many alternative energy investments to a fraction of actual construction and installation costs. At present, the utilization of BETCs by developers of many alternative energy projects is hampered by uncertainty regarding the DOE’s exercise of its regulatory authority. Hopefully, those uncertainties will be resolved in the coming months.

Endnotes

- 1 See HB 3201, which may be viewed at the following address: <http://www.leg.state.or.us/07reg/measpdf/hb3200.dir/hb3201.en.pdf>.
- 2 See HB 3619, which may be viewed at the following address: <http://landru.leg.state.or.us/08ss1/measpdf/hb3600.dir/hb3619.en.pdf>.
- 3 Section 26, chapter 843, Oregon Laws 2007.
- 4 See, e.g., Internal Revenue Code sections 45 (production tax credit for electricity produced from certain renewable resources) and 48 (investment tax credit for certain energy property).
- 5 See ORS 469.185 and ORS 469.205(2)(a).
- 6 Both the 50% credit and the 35% credit are allowed in their entirety in the first year of the five-year period for which the certification is effective if the certified cost of the facility in question does not exceed \$20,000. ORS 315.354(1)(b).
- 7 See the DOE’s web page titled “Business Energy Tax Credit Pass-Through” at <http://www.oregon.gov/ENERGY/CONS/BUS/tax/pass-through.shtml>.

Tax Aspects of Marriage and Divorce; *Similarities and Contrasts With Domestic Partnerships*

By Michael C. Wetzel

I. Overview

The 2007 legislature passed and the Governor signed HB 2007, the Oregon Family Fairness Act (OFFA). The OFFA authorizes same sex couples to register as a domestic partnership. The OFFA has generated a number of tax questions with respect to domestic partners. This article attempts to address some of those questions.

The tax aspects of marriage, divorce, and domestic partnerships in Oregon are governed primarily by four different, sometimes inconsistent, bodies of law. At the federal level, the tax laws are contained in the Internal Revenue Code, Title 26, United States Code ("IRC"). However, the Defense of Marriage Act (DOMA), P.L. 104-199 (1996), 1 USC 7, limits for federal purposes, including taxation, the definition of marriage to "a legal union between one man and one woman..."

Oregon's relevant tax laws are found at ORS chapters 118 (inheritance tax), 305 (tax procedure), 314 and 316 (income tax) and now, the OFFA (which has not been codified). Oregon's tax laws are largely (but not entirely) tied to the IRC and federal tax law concepts. The OFFA contains a number of provisions specific to the tax laws. Section 9(8) provides that for purposes of administering Oregon's tax laws, domestic partners, and their children have the same rights and responsibilities as are granted or imposed on spouses of a marriage. Section 11 of the OFFA provides that ORS chapter 314 applies to domestic partners as if federal income tax law recognized a domestic partnership.

The OFFA was scheduled to be effective January 1, 2008. However, on December 31, 2007, United States District Judge Michael Mosman entered a temporary restraining order and preliminary injunction staying the January 1, 2008, effective date. Lemons v. Bradbury, U.S. District Court for the District of Oregon (No. CV-1782-MO). The plaintiffs in that matter allege that county officials and the Oregon Secretary of State wrongfully excluded their

signatures on petitions to repeal the OFFA. The plaintiffs claim such actions violate equal protection and procedural due process under the First and Fourteenth Amendments of the U.S. Constitution, as well as similar provisions of the Oregon Constitution. On February 1, 2008, Judge Mosman issued an opinion refusing to grant a permanent injunction, thus removing this obstacle to the OFFA's implementation.

II. Property Transfers.

A. In General.

As a general rule, the sale or exchange of property generates recognized gain (or loss) to the extent the consideration received exceeds the adjusted basis of the property. IRC §1001. However, under IRC §1041, no gain or loss is recognized for transfers of property between spouses, or between former spouses if the transfer is incident to divorce. The transfer is treated as a gift for income tax purposes.

Because of DOMA, IRC §1041 does not apply for federal tax purposes to the transfer of property between domestic partners. But IRC §1041 will apply for Oregon income tax purposes under the OFFA. For federal purposes, the parties (and the IRS) have a number of options, including:

- 1) Treat the transfer as a sale or exchange: if the partners swap properties or interests in properties, each will recognize gain to the extent the fair market value of the property received exceeds the adjusted basis of the property transferred. This may be the preferred treatment in a dissolution context if the bases in property are close to the fair market value. If the parties exchange properties of a like kind, IRC §1031 may help defer gain.
- 2) Treat the transfer as a gift: gifts are excluded from gross income under IRC §102; however, gifts in excess of the annual exclusion amount (\$12,000 currently) have gift tax consequences under IRC §2501 et. seq.

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- 3) Treat the transfer as compensation: subjecting the recipient to ordinary income tax and self employment tax and subjecting the transferee to potential gain (probably not a favored result).

The preferred tax treatment will depend on the specific facts of each case. Note also that IRC §1041 applies a non-recognition rule to losses as well as gains. In the case of a transfer of loss property, a domestic partner may actually fare better under federal tax law than state tax law. See also IRC §267, disallowing losses between related taxpayers, including “spouses.”

B. Personal Residence.

Under IRC §121, generally, an individual may exclude up to \$250,000 of gain from the sale of a personal residence if owned and used as the principal residence for at least two out of the five previous years. For a husband and wife filing a joint return, the maximum exclusion is \$500,000 if either meets the ownership requirement and both meet the use requirements. Again, because of DOMA, domestic partners may not take advantage of the provision for a husband and wife for federal income tax purposes. However, each domestic partner may claim a \$250,000 exclusion, so long as both meet the ownership and use requirements. For Oregon income tax purposes it is possible that the married exclusion of \$500,000 may be available even though only one of the domestic partners satisfies the ownership requirement.

In the dissolution context, two special rules apply under IRC § 121(d)(3):

- 1) A divorced spouse who still owns an interest in the residence is treated as using it as a principal residence during the time it is occupied by the former spouse (the “kicked out spouse rule”); and
- 2) A spouse who receives title in an IRC §1041 transfer can tack the ownership of the transferor (applies to both current spouses and divorcing spouses).

The benefits under IRC §121 provided to spouses will not apply to domestic partners for federal tax purposes, but would appear to be available for Oregon income tax purposes.

C. Other Situations.

1) Redemption of Corporate Stock.

The taxation of corporate stock redemptions in the marriage and divorce context has long been a trap for the unwary. Because domestic partners are precluded from IRC §1041 treatment for federal tax purposes, either a redemption or a transfer to the other partner will be a taxable event under federal tax law. However, because of the danger of dividend treatment and the application of IRC §1041 for Oregon income tax purposes, care is still required in dealing with this issue in the domestic partnership arena.

2) Qualified Retirement Plans.

Under the federal tax law, and ERISA, rights under most qualified retirement and individual retirement accounts are subject to anti-alienation or anti-assignment provisions. A major exception exists for transfers pursuant to divorce. See IRC §408(d)(6) for IRAs and IRC §401(a)(13)(B) and 414(p), relating to qualified domestic relations orders (QDROs) for qualified plans. If a transfer does not meet the exception, the transferor will be subject to ordinary income on the amount transferred plus a 10% penalty.

Because the plans are drafted to comply with applicable federal requirements, the plan documents themselves will generally not allow a transfer or assignment of an interest in a plan to a domestic partner. The OFFA, in sections 9(6) and 9(7), acknowledges that it does not require or permit the extension of benefits in these cases.

3) Stock Options.

Stock options come in two forms for income tax purposes: incentive stock options (ISOs) (see IRC §421-424) and non-qualified stock options. ISOs are generally non-transferrable. See IRC §422(b). Stock received from the exercise of an ISO may be transferred incident to divorce. See IRC §424(c)(4). In the context of a domestic partnership, such a transfer of stock received from the exercise of an ISO within the waiting period would be a disqualifying disposition, which would cause the option to be treated as a non-qualified stock option for federal income tax purposes.

Non-qualified stock options are freely transferrable, unless restricted by the governing instrument. The IRS, in Rev. Rul. 2002-22, held that the transferee spouse will recognize the income from the exercise of a non-qualified stock option. Rev. Rul. 2002-22 relies primarily on IRC §1041; accordingly, its analysis would not apply to domestic partners. Instead, Rev. Rul. 2002-22 indicates that the IRS would apply the assignment of income doctrine and/or a sale or exchange analysis to the transfer of non-qualified stock options between domestic partners, causing income to be recognized by the transferor.

III. Support of Dependents.

The tax laws contain a number of favorable provisions for the support of a dependent child or other dependent. These include the dependent exemption, the child tax credit, the child and dependent care credit, the earned income credit and the Hope and Lifetime Learning Credits.

The OFFA provides in sections 9(3) and 9(4) that the rights and responsibilities granted to a spouse or former spouse with respect to a child or either spouse shall be equivalent in the case of domestic partners. For Oregon income tax laws, a domestic partner should be able to claim stepchildren (i.e. the children of the other domestic partner) as dependents, relying on the definition of child in IRC §152(f)(1). However, for federal income tax purposes, the domestic partner would need to adopt the child or children of the other partner before he or she were able to claim the full tax benefits for supporting the child. A domestic partner may be able to claim the other partner as a dependent on his or her federal return if the other partner meets the definition of a qualifying relative.

IV. Spousal Support.

Qualifying spousal support, called alimony or separate maintenance under the tax code, is tax deductible to the payor under IRC §215, and includable in the payee's income under IRC §71(a).

Because alimony payments must be made to or for the benefit of a spouse to qualify under IRC §71(b), spousal support payments (or their equivalent) to former domestic partners will not be deductible by the payor or includable in the payee's gross income

for federal tax purposes, at least not under IRC §71. However, such payments are likely to have some tax consequences, either as:

- 1) Payment for the release or transfer of property rights. See *Reynolds v. Comm'r*, T.C. Memo 1999-62 (1999). The recipient would recognize gain, possibly under the installment method, to the extent the payments exceed his or her adjusted basis in the property transferred. The payer would add the payments to his or her basis.
- 2) A gift.
- 3) Compensation for past services.

Domestic partners should be able to receive alimony treatment for Oregon tax purposes.

V. Filing Status and Liability Relief.

A. Filing Status.

Married individuals or surviving spouses in the year of death may file a joint federal income tax return. IRC §6013 and 7703. For a married couple with widely unequal incomes, filing jointly will generally result in less overall tax. However, a married couple with two equal incomes, especially as high earners, will generally pay more in taxes than if they were each filing as unmarried individuals. The married filing separately option does not alleviate the marriage penalty, and in fact many tax benefits are not available to married filing separately individuals, such as the educational tax credits, earned income credit, child care credit, credit for adoption expenses, the ability to elect to claim the standard deduction if the other spouse itemizes, and the student loan interest deduction.

If domestic partners are both high earners, they will generally be better off tax-wise than similarly situated married individuals, since they will be able to file their federal return as unmarried individuals. Domestic partners with only one income earner will generally not fare as well. However, if the income earner qualifies as head of household for tax filing purposes, either because he or she provides more than half the support to a qualifying child or other person who is a dependent (including possibly the other domestic partner), the tax liability will generally be lower than filing single, though perhaps still not as advantageous as married filing jointly.

For Oregon income tax purposes, domestic partners should be able to file joint returns if they so choose, notwithstanding ORS 316.367, which requires consistent filing of federal and state returns.

B. Liability Relief.

Under IRC §6013(d)(3), individuals filing a joint return have joint and several liability for all tax shown on the return and any additions to tax for that tax year. Nonetheless, under IRC §6015, a joint filer can obtain relief as an “innocent spouse” if he or she can show that (1) there was an understatement of tax attributable to the other filer, (2) the individual had no reason to know of the understatement, (3) it would be inequitable to hold the individual liable for the understatement, and (4) the individual timely requests relief. IRC §6015(b). An individual may also seek to apportion the tax liability if no longer married to (or legally separated from) or no longer living with the other filer (IRC §6015(c)) or can seek equitable relief under all the facts and circumstances (IRC §6015(f)).

Because domestic partners will not be able to file joint federal returns, relief from joint liability will not be an issue at the federal level. Oregon allows joint filers to request equal division of joint tax liability if the individuals are no longer married (or are legally separated) under ORS 316.368. Oregon also allows innocent spouse relief when granted by the IRS, or if the IRS has not made a determination, under Department of Revenue rules that generally mirror IRC §6015. Domestic partners should be eligible for this type of relief at the state level.

VI. Estate and Gift Tax.

The Internal Revenue Code imposes a tax on transfers made at death under IRC §2001 (the estate tax), and gifts made during life under IRC §2501 (the gift tax). An unlimited estate tax deduction exists under IRC §2056 for transfer to a surviving spouse so long as he or she is a U.S. citizen. A similar gift tax deduction exists under IRC §2523 for lifetime transfers to spouses who are U.S. citizens. A separate gift tax exclusion under IRC §2516 applies to certain property transfers between former spouse pursuant to a property settlement agreement.

Domestic partners will not be able to take advantage of the federal spousal deductions and exclusions

pursuant to DOMA. Accordingly, any lifetime transfer without consideration is a taxable gift, whether during the domestic partnership or on its dissolution. If the transfer exceeds the \$12,000 annual gift tax exclusion, a gift tax return is required to report the taxable gift.

Likewise, transfers to the domestic partner at death will not qualify for the federal estate tax marital deduction. Thus, such transfers in excess of the applicable exclusion amount (currently \$2,000,000) will be subject to estate tax.

Oregon has a separate inheritance tax (but no gift tax). The Oregon inheritance tax applies to taxable estates in excess of \$1,000,000. Oregon (in similar fashion as the federal rules for estate tax) allows for a marital deduction. In addition, the Oregon special marital property election under ORS 118.013 allows an Oregon marital deduction for certain trusts not qualifying for QTIP status under the IRC. Oregon domestic partners should be able to take advantage of the Oregon marital deduction and the Oregon special marital property election. Thus, the value of assets transferred on death to a domestic partner should not generate an Oregon inheritance tax pursuant to the OFFA.

This article addresses some of the tax issues prompted by the OFFA. Others will undoubtedly arise in the next few years. Some of those questions may concern other states' tax treatment of Oregon domestic partners for death tax purposes, nonresident and part year resident income tax filing, and community property tax issues. Related but substantive nontax issues are also on the horizon in the area of intestate inheritance.

Changes to Oregon Inheritance Tax Exclusion for Natural Resource Property

The Governor signed HB 3618 on March 11, 2008. It substantially revises the ORS 118.140 inheritance tax exclusion for natural resource property and commercial fishing property. (The original legislation was passed as HB 3201 in the 2007 legislative session.) A detailed analysis will be provided in a future issue.

Ten Things Every Tax Lawyer Should Know About Tax Liens

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The lien established in section 6321 is the foundation for collection of all taxes imposed by the Internal Revenue Code. It is one of the most formidable debt collection devices ever established by American law. No other encumbrance has a more devastating effect on an individual's creditworthiness and financial relationships.

Problems with collection of a tax arise more frequently than tax audits. Collection problems, unlike tax audits, can affect persons other than the taxpayer. The federal tax lien laws are unique and complex. Here are ten fundamental aspects of the tax lien every tax lawyer should know.

1. The tax lien comes into existence with assessment of the tax. Section 6322 states that "the lien imposed by section 6321 shall arise at the time the assessment is made." Once the lien has arisen, it attaches to all property belonging to the taxpayer and thereby empowers collection through levy. In the absence of jeopardy, the IRS cannot actually seize property unless the taxpayer fails to file a collection due process appeal under section 6330 after the IRS has issued a formal final notice of intent to levy. The IRS need not, however, file a notice of the tax lien to seize. The "secret lien" (that is, the tax lien before its existence is published through the filing of a notice of lien) empowers seizure, and will have priority over many competing interests from the date of assessment. *US v. City of New Britain, Connecticut*, 347 US 81, 74 S Ct 367 (1954).

2. The rights of the government under a federal tax lien are determined exclusively under federal law. The federal tax lien attaches to "all property and rights to property, whether real or personal, belonging to [the taxpayer]." IRC ' 6321. "[S]tate law controls in determining the nature of the legal interest which the taxpayer [has] in the property." *Morgan v. Commissioner*, 309 US 78, 82, 60 S Ct 424, 426 (1940). "However, once the tax lien has attached to the taxpayer's state-created interests, we enter the

province of federal law, which we have consistently held determines the priority of competing liens asserted against the taxpayer's '>property' or 'rights to property.'" *quilino v. US*, 363 US 509, 513-14, 80 S Ct 1277, 1280 (1960). Further, "[t]he question of whether a state-law created right constitutes '>property' or '>rights to property' under section 6321 is a matter of federal law." *Drye v. US*, 528 US 49, 50, 120 SCt 474, 477 (1999).

3. There are exemptions from levy, but no exemptions from the tax lien. Case law uniformly holds the word "all" really means all regarding the property attached by the lien. Section 6334 defines thirteen categories of property that are exempt from administrative seizure or levy, but exemptions from levy should not be confused with exemptions from lien. Treas. Reg. section 301.6321-1 defines the sole exemption recognized from the federal tax lien: "any interest in restricted land held in trust by the United States for an individual noncompetent Indian (and not for a tribe)." Property exempt from levy is still subject to the federal tax lien, and the IRS bears the right to pursue such items through judicial foreclosure and is entitled to a secured claim in bankruptcy for any such property.

State law property exemptions do not apply to the federal tax lien. *US v. Mitchell*, 403 US 190, 204, 91 S Ct 1763 (1971). The tax lien thus pierces homestead and wage exemptions that curtail the rights of other creditors. It attaches to IRA accounts and beneficial interests subject to spendthrift clauses, and reaches social security and worker's compensation payments. See IRC ' 6334(c), and *Drye v. United States*, *supra*.

4. The normal ten-year life of a tax lien can be extended indefinitely. The lien exists until the tax liability "is satisfied or becomes unenforceable by reason of lapse of time." IRC ' 6322. The normal statute of limitations is "10 years after the assessment of the tax." IRC ' 6502(a)(1). The statute is extended when taxpayers pursue various forms of relief from

collection of the tax, such as the filing of bankruptcy (section 6503(h)), an innocent spouse claim (section 6015(e)(2)), a collection due process appeal (section 6330(e)), or an offer in compromise. Treas. Reg. ‘ 301.7122-1(i).

Additionally, the government may choose to “reduce the tax liability to judgment” at any time before the normal statute of limitations expires, and thereby gain additional time to pursue collection. To do so, the government need only commence suit and obtain a judgment finding the taxpayer liable for the tax. The judgment allows the IRS to pursue collection of the tax for another ten years, and the government may renew the judgment thereafter indefinitely. Section 6322 continues the tax lien for the period of the judgment, thereby allowing continued collection through administrative levy.

5. In Oregon, the IRS must file a notice of tax lien in the Secretary of State’s UCC office to perfect the lien on personal property, and with the recording office for the county where real property is located to perfect on real property. The IRS must file a notice of federal tax lien before the lien will compete in priority with certain other interests. IRC ‘ 6323(a). Section 6323(f) allows each state to designate the state office where a notice of federal tax lien must be filed to perfect the lien on real and personal property. Oregon has designated the Secretary of State’s UCC registration office as the filing location for perfection of a federal tax lien on personal property, and the recording office for the county where real property is located for perfection on real property. ORS 87.806.

6. Perfection of a tax lien is only material with four types of interests and bankruptcy. Under section 6323(a), a tax lien is not “valid as against any purchaser, holder of a security interest, mechanic’s lienor, or judgment lien creditor until notice thereof . . . has been filed by the Secretary.” In other words, a federal tax lien does not compete for priority with these types of interests until the IRS has perfected the tax lien by filing or recording a notice of the lien.

By negative implication, notice of the tax lien need not be filed/recorded for the lien to “be valid as against” (that is, “prevail over”) interests that are not identified in section 6323(a). For example, an unrecorded federal tax lien has priority over state

tax liens, agricultural liens, and landlords liens that arise after the federal tax lien comes into existence. Transferees of property who do not pay sufficient value to qualify as a “purchaser” under section 6323(a) (e.g. recipients of gifts) receive the property with any pre-existing federal tax liens still attached, even if the IRS never recorded a tax lien notice at all.

In cases where lien priority is not determined by filing/recording, the tax lien’s priority is measured by reference to the assessment date, when the tax lien becomes “choate.” *US v. City of New Britain, Connecticut*, 347 US 81, 74 S Ct 367 (1954). A lien becomes choate “when the identity of the lien or, the property subject to lien and the amount of the lien are established. *City of New Britain*, 347 US at 84, 74 S Ct at 369. Assessment of the federal tax satisfies the three choate requirements, and the federal tax lien’s priority is accordingly measured by the assessment date. The date an agricultural, landlords, or other statutory lien becomes choate is determined by reference to the provisions of state law that create the lien.

In instances where the taxpayer files bankruptcy, the IRS cannot have a secured claim within the bankruptcy case unless it filed a notice of lien against the taxpayer before bankruptcy was commenced. 11 USC ‘ 506(a). If no lien notice was filed, any taxes due will be treated as unsecured claims, despite the secret lien.

7. An attorney’s lien prevails over a federal tax lien, regardless of when the tax lien arose and was perfected. Section 6323(b) grants ten types of interests “super-priority” over federal tax liens. These interests will always prevail over a federal tax lien, regardless of when the lien came into existence and was perfected. Attorneys who have liens or enforceable contracts against judgments or amounts recovered through settlement are granted super-priority to the extent of the “reasonable compensation” for obtaining the recovery. However, in cases where the judgment or settlement is obtained against the federal government, plaintiff’s attorney cannot claim the super-priority with any portions of the recovery that the government is entitled to offset against taxes owed by plaintiff.

8. Purchasers of motor vehicles or securities who do not have actual knowledge of a tax lien can acquire the securities or motor vehicle free

and clear of the lien. Registration with the department of motor vehicles is the standard means of perfecting interests in motor vehicles in all fifty states. Congress did not want to confound vehicle sales for consumers by requiring them to check for filed notices of tax lien before they purchase a car. Purchasers of vehicles are granted super-priority over federal tax liens as long as they do not have actual knowledge the lien exists. IRC ‘ 6323(b)(2).

9. Federal tax liens generally prevail over all other interests on after-acquired property. The Supreme Court’s decision in *US v. McDermott*, 507 US 447, 113 S Ct 1526 (1993), confirms the priority of the federal tax lien on property a taxpayer acquires after a federal tax lien is perfected. The tax lien was held to prevail over a judgment lien against the taxpayer on real property the taxpayer acquired after the tax lien had been perfected. The tax lien and competing judgment lien attached to the real property when the taxpayer acquired it. Section 6323(a) was deemed to give priority to the tax lien since it had been perfected prior to the date the liens attached, even though both interests attached simultaneously.

When the tax lien competes with interests that do not require the filing of a notice of tax lien (*see* 6 above), the tax lien generally prevails over competing interests from the date the tax is assessed. *US v. City of New Britain, Connecticut*, 347 US 81, 74 SCt 367 (1954). If the filing of a notice of lien is not material to the tax lien’s priority against another interest, the tax lien will generally have priority over all property the taxpayer acquired after the tax was assessed. *US v. Graham*, 96 F.Supp. 318, 321 (SD Cal 1951); *aff’d sub nom. California v. US*, 195 F2d 530 (9th Cir 1952) *cert. denied*, 344 US 831.

10. Qualifying commercial and construction lenders and sureties get forty-five days of relief from the after-acquired property rule. Section 6323(c) carves out a series of limited exceptions to the general rule that the tax lien prevails on receivables and inventory a taxpayer acquires after a tax lien has been perfected for certain commercial lending arrangements, sureties, and construction loans. These provisions are so complex that the Fifth Circuit Court of Appeals began one of the earliest cases on the statute by observing: “We enter with some trepidation the tortured meanderings of federal tax lien

law.” *Texas Oil & Gas Corp. v. US*, 466 F2d 1040 (5th Cir. 1972). These relief provisions are intended to ameliorate the diminution in collateral certain commercial lenders would otherwise suffer when their security rights over receivables and inventory the taxpayer acquires in the future are cut off by perfection of a tax lien.

Under section 6323(c), qualifying lending arrangements are granted first priority on collateral the taxpayer acquires within 45 days after the lien notice filing. In the absence of actual knowledge of the lien filing, lenders can also receive first priority on qualifying collateral for additional loans or disbursements made during the 45-day period. Revenue Ruling 68-57 provides additional relief from the after-acquired property rule for purchase money security interests.

Upcoming Events:

June 12, 2008: Taxation Section Luncheon featuring Jan Bennett Geier (Associate Area Counsel, IRS): Preparer Penalties and Disclosure Under Section 6694 and Circular 230

June 20, 2008: OSB CLE: Advanced Estate Planning

August 14, 2008: Taxation Section Luncheon featuring Vincent P. Cacciottoli: 409A – Do They Really Mean It This Time?

October 2, 2008: Taxation Section Luncheon featuring David C. Culpepper: Retroactive Tax Planning: When Can You Say “Oops” and Fix a Problem?

October 19-24, 2008: NYU’s 67th Institute on Federal Taxation

November 13, 2008: Taxation Section Luncheon featuring J. Alan Jensen: Estate and Gift Tax Issues That Income Tax Lawyers Need to Know About

December 18, 2008: Taxation Section Luncheon featuring Mark A. Prater: Washington DC Update

Notification Regarding Updated Web Site:

The Taxation Section has updated its web site, which can be found at <http://osbtaxation.homestead.com/Index.html>. The Web site has the past issues of the Taxation Newsletter along with other helpful resources. Please take a moment to review it. If you would like to see anything added to the site, please contact one of the Executive Committee members.

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